IN THE

Supreme Court of the United States

OCTOBER TERM, 1944

No. 354

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

against

ELLIOTT H. WHEELER, *et al.*, Executors of the Estate of JOHN H. WHEELER, *et al.*,
Respondents.

PETITION FOR REHEARING AND MOTION TO WITHHOLD ISSUANCE OF MANDATE

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Executors of the Estate of JOHN H. WHEELER, Deceased, *et al.*,
Respondents,

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April 17, 1945.

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To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Introductory

In this case (i) the deficiency assessment was based on a 1940 statute, (ii) which statute was the sole basis of the decision (a) of the Tax Court (that it was retroactively valid) and (b) of the Circuit Court of Appeals (that it was unconstitutionally retroactive).

And it was solely on the issue of the 1940 Act that the writ was granted in this case:

> "The Circuit Court of Appeals for the Ninth Circuit has held Section 501(a) of the Second Revenue Act of 1940 to be unconstitutional. This

> *of course* called for grant of certiorari" (Slip Op. 1). (Emphasis ours.)[1]

This Court then decided the case on an entirely different point—that the case was ruled by a regulation first introduced in 1935, under the Revenue Act of 1934.

It is not true, as the Court supposed (Slip Op. 3) that the Commissioner has "persisted in applying" his present interpretation of the regulation. He argued in other cases both in the Tax Court and in the Circuit Court of Appeals that it should be given our interpretation.

But the Tax Court was consistent in its rulings opposed to the interpretation now given by this Court.

The Court disposed of the Tax Court's decisions in the following sentence (Slip Op. 3):

> "The only reason to doubt the *validity* of the regulation is found in certain[2] decisions of the Board of Tax Appeals and lower Courts, mentioned in the Tax Court's opinion." (Emphasis ours)

This Court thus assumed that the regulation was susceptible to only one *interpretation* and that the issue was as to its *validity*. We submit that if we can establish that there is an open question as to the *meaning* of the regulation, this Court should consider it upon a rehearing. We presume that this Court will be astute to avoid the peculiarly unfortunate position that must occur when the highest ap-

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[1]We assume that it is a fair assumption that, in the absence of a conflict of circuits (and there is none), the Court would not have granted certiorari merely to review the interpretation of the regulation; nor indeed did the 9th Circuit Court of Appeals interpret it.

[2]The "certain" decisions of the lower courts to which this Court referred were *all* the decisions on the subject.

pellate Court has been constrained to decide a point hardly noticed below and inadequately argued here. We are in effect appealing from this Court to this Court; and it is our first appeal on the issue on which the Court founded its first opinion.

We take the entire blame for not adequately carrying home to this Court on the first hearing that there was a serious issue to be considered as to the meaning of the regulation.

If we are right in our view that there be such an issue, we assume that the Court will wish to determine it, not *a priori* by merely reading the regulation, but in the light of its history. We will argue that after considering that history, this Court must come to the conclusion alternatively (a) that it misinterpreted the regulation, or (b) that at least the line of authority in the Tax Court supporting and applying the contrary interpretation is so strong that the question was not open in this Court if the rule in the *Dobson* case, 320 U. S. 489, at pp. 498-507, is still law.

This Court's disregard of the Tax Court's interpretation cannot be reconciled with the rule laid down in the *Dobson* case as to the weight to be attached to Tax Court decisions. It is noteworthy that on the very day that this Court's opinion was announced, the 6th Circuit Court of Appeals (in a case to which the 1940 Act was inapplicable) made a contrary decision upon precisely the same point, solely upon the ground that it was required so to do by the decision of this Court in the *Dobson* case. *Commissioner v. Fisher*, (C. C. H. Tax Service par. 9239). So dramatic a coincidence must at least result in this case causing a searching re-examination of the *Dobson* principle by the legal and accounting professions. We submit that under these circumstances it becomes fitting for this Court itself

to re-examine the grounds of its decision, when it be borne in mind that the circumstances under which it first came here for review necessarily deprived the Court of the full assistance of counsel upon the point upon which it was decided.

The earlier opinion of this Court proceeds throughout upon the assumption that there was something that may properly be called "the regulation". "The regulation" referred to is but the third sentence in a paragraph.

Under a basic principle in the interpretation of statutes, the paragraph must be read as a whole. When so read, it appears that the third sentence was in effect a footnote to the second sentence.

The applicable rule was stated for the Court by the present Chief Justice in *Helvering* v. *Morgan's, Inc.*, 293 U. S. 121, 126:

> "But the true meaning of a single section of a statute in a setting as complex as that of the revenue acts, however precise its language, cannot be ascertained if it be considered apart from related sections, or if the mind be isolated from the history of the income tax legislation of which it is an integral part. See *Helvering* v. *New York Trust Co.*, 292 U. S. 455, 464."

The principle must be *a fortiori* applicable to a single sentence within a paragraph. And see *United States* v. *American Trucking Associations*, 310 U. S. 534, 542, 544.

Summary

First. The primary grounds for rehearing are:

1. That the Commissioner has not "persisted in" his present interpretation of the regulation.

2. That the Tax Court *has* persisted in the interpretation of the regulation contrary to that assumed by this Court.

Second. If we are right in either or both of these propositions, then the bases of this Court's earlier opinion fall, and it becomes appropriate in the interests of justice that there be a fresh examination of the regulation.

On such examination we will submit

(a) That the Tax Court's interpretation is correct when the sentence from the regulation is read in its context, which deals with actual gains and losses.

(b) That the Congress showed no intent to include in earnings and profits anything but actual gains and losses.

(c) That this Court's interpretation of the regulation produces distortion of earnings and profits in reorganization cases.

Third. If this Court does not wish to reconsider its interpretation, still the present case must be decided otherwise because of its special facts. Proceeding upon the assumption that the theory of this Court's decision is correct, the regulation cannot be applicable to turn the Wheeler Company's deficit into earnings:

(a) The transactions in question occurred prior to the first adoption of the regulation under the Revenue Act of 1934.

(b) If earnings and profits, under the theory of this Court's decision, be determined by taxable income, rather than actual income, the Wheeler Company still

had a deficit, for the non-taxable dividends to it must then be deducted.

ARGUMENT

PART ONE

The Court's Interpretation of the Regulation Cannot Be Supported.

I.

In six successive cases between 1938 and 1944 the Board of Tax Appeals and Tax Court gave to the statute an interpretation contrary to that assumed by this Court. That was a reasonable interpretation.

Therefore the decision of this Court cannot stand without amounting to an overruling *sub silentio* of the *Dobson* case, 320 U. S. 489.

In each of the six cases the factual situation was like that in the *Wheeler* case. The taxpayer was a stockholder. The question was whether the taxpayer received a dividend out of earnings or profits. The corporation from which it received the dividend had in each case acquired property in a tax-free reorganization and had thereafter sold the property. The question was therefore whether the basis to the corporation was its own accounting basis or was its transferor's basis.

In each of the cases the Tax Court held that it was the actual basis of the transferee corporation and not the transferor's basis that governed.

The first case was *W. S. Farish & Co.* (July 22. 1938) 38 B. T. A. 150. As in *Wheeler*, transferee's basis was

higher than transferor's. Therefore the Commissioner claimed that transferor's basis governed. The Board wrote a long opinion to the contrary, holding that earnings or profits were related to *actual* gains and losses of the corporation as such. The opinion was reviewed by the Board. It was then affirmed on appeal in 1939 (C. C. A. 5th) 104 F. (2d) 833, and the Commissioner did *not* apply for a writ of certiorari.

The case was argued in the Board of Tax Appeals about three years after the adoption of the "regulation", but the regulation was not mentioned by the Commissioner. It is therefore impossible to say that he was then "persisting" in a position which he was not even suggesting.

The regulation had issued 3 years before—on February 11, 1935, under the Revenue Act of 1934.[3]

The second case before the Board of Tax Appeals came three months after the *Farish* case. *W. & K. Holding Corporation* (Oct. 1938) 38 B. T. A. 830. This case presented the same issue as in the *Wheeler* and *Farish* cases, but the position of the parties was reversed, as transferor's basis was higher than transferee's.

The Commissioner argued exactly the opposite of what he is arguing here. He argued that transferee's basis governs,—that earnings and profits under the statute mean actual earnings and profits.

We submit that this wholly destroys the assumption by this Court that the Commissioner "persisted" in the view that he has presented here.

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[3]At the time of insertion in the regulation of the sentence under review, Mr. Justice Jackson was the chief legal officer of the Bureau of Internal Revenue.

The decision was in favor of the Commissioner. Again the case was reviewed by the whole Board, and although four members dissented, the dissenting opinion shows that it was based upon other grounds. Evidently the Board was unanimous in its adoption of the rule for which we are now, and the Commissioner was then, contending.

The third case was *Dorothy Whitney Elmhirst* (Feb. 1940) 41 B. T. A. 348. Here, as in the *Farish* and *Wheeler* cases, transferor's basis was lower, so the Commissioner was now arguing against the established rule. The 1934 Act was involved. Yet the Commissioner evidently did not rely on the regulation, and it is not mentioned in an extensive opinion. Again the decision was reviewed by the Board, and the already established rule was unanimously approved.

The fourth case was *Falkland Corporation* (not officially reported, C. C. H. Dec. 12,170-A, decided Nov. 1941). Transferor's basis was lower, and the decision was in favor of the taxpayer corporation which was claiming a dividends paid credit.

Falkland was the first case in which the Commissioner based an argument upon the regulation. Indeed, he attempted to distinguish the next preceding (*Elmhirst*) case by saying that he had not there relied upon the regulation. Of course, the distinction was fallacious, because the meaning of the statute did not change depending upon what argument was made upon it.

The important point is that the fact that the Commissioner never argued that the regulation applied to a case of this character until July 1941—more than six years after the adoption of the regulation—shows how misled this Court was in supposing that the Commissioner had been persisting in applying the regulation. He just was not applying it at all; and it was not until after the enactment of the 1940 Act and *after* the deficiency assessment in the *Wheeler* case that he first argued that the regulation applied to a case of the *Wheeler* type.

But by that time the contrary interpretation of the regulation had been established by the three cases above cited. *Farish. W. & K. Elmhirst.* It had become established as strongly as any tax rule could ever be established by the Board of Tax Appeals, for in the three cases there had been an opportunity for the Commissioner to argue on both sides of the point, and every one of the three cases had been consistently decided and also reviewed by the full Board.

The fifth and sixth cases presented the same fact situation as the *Farish* case, and they followed and applied *Elmhirst.* They were *Senior Investment Corporation* (1943) 2 T. C. 124, 139, and *Estate of Fred J. Fisher* (not officially reported, C. C. H. Dec. 13,734M, Feb. 9, 1944). The *Fisher* case was the case affirmed on March 26, 1945, by the 6th Circuit Court of Appeals on the authority of the *Dobson* case.

The following quotations are characteristic of the Tax Court's decisions:

> "Earnings available for dividends are computed upon actual gains or losses of the corporation as of the date of the distribution." *W. & K. Holding Corporation,* 38 B. T. A. 830, 841 (1938).

> "It is the *actual* gain or loss which affects the corporation's capital and determines whether there is earned surplus, or a deficit which impairs the capital." *W. S. Farish & Co.,* 38 B. T. A. 150, 158 (1938).

> "However, the gain or loss reflected by the use of the transferor's basis is not the true or actual gain or loss as it affects the capital of the corporation. Whether a corporation has an earned surplus or a deficit which impairs capital is to be determined on

> the basis of the actual gain or loss, and the actual gain or loss is to be measured by the cost of the property to the corporation, which, in a case such as the instant one, is the fair market value of the property received in exchange for all of its capital stock." *Senior Investment Corporation*, 2 T. C. 124, 139 (1943).

The rule laid down by the Tax Court that corporate earnings and profits are to be determined by *actual* gains and losses was a reasonable rule and the one which causes less distortion in the long run than any other. Certainly there should be *compelling* reasons for abandoning it.

The Tax Court decisions interpreted a statutory phrase ("earnings and profits") which the Congress did not define until 1940. Accordingly, the statute which the Tax Court construed remained substantially unchanged from the Revenue Act of 1916 to the Second Revenue Act of 1940. If any presumption be applicable, it must be that Congress had knowledge of the Tax Court interpretation of the statute, which was re-enacted without change until the Second Revenue Act of 1940.

The rule relating to re-enactment of revenue acts by the Congress without change after they have received an administrative interpretation must be as applicable to a consistent line of decisions by the Tax Court as to a sentence in a regulation. Here the decisions were unequivocal; whereas the sentence in the regulation was, if not inapplicable, at least of doubtful applicability.

Indeed, this rule of law established by the Tax Court is likewise a rule of tax accounting, for it is dealing with a section of the statute whose purpose was to define the source of dividends, viz. (to quote the regulation) from "corporate earnings or profits". It is thus entitled to the

support of this Court under the language of the opinion in the *Dobson* case both as relating to law and as relating to accounting (pp. 502, 506):

> "In deciding law questions courts may properly attach weight to the decision of points of law by an administrative body having special competence to deal with the subject matter. The Tax Court is informed by experience and kept current with tax evolution and needs by the volume and variety of its work. While its decisions may not be binding precedents for courts dealing with similar problems, uniform administration would be promoted by conforming to them where possible.
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> "We only hold that no statute or regulation having the force of one and no principle of law compels the Tax Court to find taxable income in a transaction where as matter of fact it found no economic gain and no use of the transaction to gain tax benefit. The error of the court below consisted of treating as a rule of law that what we think is only a question of proper tax accounting."

The Wheeler Company had no economic gain from the sales of property at less than cost, and since it was required, in computing its income tax, to use the low basis of its transferors, it gained no tax benefit from such sales.

The Wheeler Company did not of course realize any actual gain on the sale of property at a loss, i.e. at less than the Company paid for it. As this Court said in *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, 185:

> "Understanding the term in this natural and obvious sense it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo."

We fail to understand what this Court means when it says in its opinion (Slip Op. p. 4):

> "But to recognize the increment in value as affecting earnings and profits would no more harmonize with the taxless character of the transaction than to treat a realized gain as doing so."

It would appear to us that this Court's decision did recognize "the increment in value as affecting earnings and profits". The Wheeler Company could realize no gain by selling at a loss. What this Court has done has been to include in the Company's earnings and profits the increment in value which occurred while the property was held by the transferors and thus to recognize that increment in value as affecting earnings and profits.

II.

The Commissioner did not persist in applying the regulation in the sense supposed by this Court.

This will already have become apparent. We need to add here only the comment that the true course of the attitude toward the regulation within the Bureau of Internal Revenue appears to have been that during the first six years of its existence it was not interpreted as applying to a case of the *Wheeler* type. This fits in with the fact apparent in the record of this case—that the *Wheeler* deficiency assessment of February 1941 still made no reference to the regulation and was based exclusively upon the conception that the 1940 Act applied retroactively (R. 12-13).

We now give the history of the regulation[4]: The regulations under the 1932 Act (Art. 623 of Regs. 77), contained this sentence:

> "In determining whether a dividend is out of earnings or profits accumulated since February 28, 1913, or prior to March 1, 1913, due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive."

The apparent purpose was to insure that accounting substance should be followed rather than accounting form. "The facts" were the facts relevant to whatever might be the conception of "earnings or profits" in corporate law generally. They were not to be subverted by "mere bookkeeping entries."

An additional regulation in Regs. 77 (prior to 1934) was Art. 621:

> "The term 'dividends' for the purpose of Title I * * * comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of its earnings or profits accumulated since February 28, 1913."

This was followed by a sentence, not here material, relating to non-taxable interest on State bonds..

In writing Regs. 86 the Commissioner inserted, after the last-quoted sentence from Art. 621 of Regs. 77, the following as the second and third sentences of the new Art. 115-1:

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[4]The regulations under the various Acts are set forth in the Appendix to this petition.

"Among the items entering into the computation of corporate 'earnings or profits' for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains or losses within the purview of section 112, are brought into the earnings and profits account at the time and to the extent that such gains and losses are recognized under that section."

The first of these sentences was thus of a general character and related to the same subject-matter as the previous sentence—actual "corporate 'earnings and profits.'" Its function was to insure that actual items would not be excluded merely because taxless. It did not change the rule of the first sentence. The paragraph as a whole deals with actual "corporate" gains or losses. Now the third sentence, with which we are directly concerned, deals with *one* of the items of such *actual* income. This item was "gains and losses within the purview of section 112". The phrase obviously covers a subject-matter with two elements: (1) gains and losses as such—*actual* gains and losses; but among those only (2) such as are purviewed by section 112, which must mean such as section 112 applies to and changes the status of, i.e., such as have existence in their quality of gain or loss independently of section 112 but to which section 112 ascribes a particular quality for tax purposes, that of non-recognition. These were to be brought in "only" at the time and to the extent recognized.

We respectfully submit that it is a complete distortion of the sentences taken together to say that the second one was intended to introduce a new and independent subject-

matter,—the subject of some form of gain or loss not actual or realized at all.

This submission on our part is strengthened by two further related considerations:

First. As thus first adopted in 1934, the second sentence under consideration referred to the taking of the gains or losses into the earnings and profits "account". This implied that it was to be taken into something that could, from the viewpoint of corporate law or accounting, be a regular corporate "account", and not something which would derive its validity only from some conception of tax law.

Second. When the word "account" was dropped out of the later redraft of the regulation—as it appears e.g. in Art. 115-3 of Regs. 101 under the 1938 Act—it was dropped out because there was incorporated into the paragraph in its first sentence the concept of corporate accounting, upon the basis of real facts, which we first quoted above from Art. 623, Regs. 77 of 1932. The combined article then read thus:

> "Art. 115-3. Earnings or profits.—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a) of the Act or corresponding provisions of

prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends."

We respectfully submit that when this paragraph is read as a whole, it will be apparent that the whole purpose was to confine "earnings or profits" to the actual facts. First, we are told that it is to the facts that consideration is to be given—not to mere bookkeeping entries. Then we are given a list of examples of typical actual income, partly taxable and partly non-taxable, but all actual. Then we are told that one of the items is not to be brought in until recognized.

The whole question in this case is whether that third sentence introduced a new subject (as this Court supposed in its earlier opinion) or whether it dealt with a particular item within the subject-matter of the two sentences which it followed.

It was apparently some time during the course of the year 1941 that it occurred to someone in the Bureau that the regulation might be argued to be applicable to the *Wheeler* type of case, for the argument made its initial appearance in *Falkland* in November 1941 and was followed in *Senior* and *Fisher* in 1943 and 1944.

By that time the Board of Tax Appeals of course considered that the contrary interpretation of the statute had

been firmly established by *Farish, W. & K.* and *Elmhirst*. It accordingly rejected the new argument in each of the three later cases—*Falkland, Senior* and *Fisher*.

Nor can it be suggested that the new argument arose out of the fact that these were the first cases dealing with a statute under which the regulation had been issued, for *Dorothy Whitney Elmhirst* was governed by the 1934 Act; yet the Commissioner did not argue that the regulation applied, although the case was considered as late as 1940.

Such suggestion would of course be without weight in any event, as the regulation purports to define and amplify the statute, not to change it. The regulation could therefore have been equally well relied upon by the Commissioner in *Farish* and *W. & K.*, each of which was decided in 1938, *ergo* more than three years after the adoption of the regulation. (Of course, if the regulation had been relied upon in *W. & K.*, the Commissioner would have had to confess error, for it was in that case that he was arguing that the statute had the opposite meaning.)

Thus we see that what the Commissioner did was to persist throughout six years in the position that the regulation did *not* apply to the *Wheeler* type of case. It is true that he twice argued that that was the true interpretation of the statute itself (albeit once he argued the contrary); but that was the argument thrice rejected by the full Board of Tax Appeals. If the *Dobson* case means anything, the Commissioner is not entitled to the application of the "principles" in regard to regulations to which this Court made reference in the final paragraph of its opinion (Slip Op. 4, and footnote 10).

We now turn to an entirely different type of case:

(a) The type that really did give rise to the regulation,

(b) and to which the Commissioner really did persist in applying the regulation.

III.

The regulation properly applies to a case in which the transferor of property in a tax-free reorganization has as a corporate accounting matter realized actual gain upon the transfer.

The question is when that actual gain is taken into earnings and profits account.

The error into which we respectfully submit that this Court fell in the first opinion in this *Wheeler* case is traceable to an omission to distinguish between cases of two diverse types and having a conflicting history.

We have reviewed the cases of the first type,—the type presented in the *Wheeler* case. Its characteristic is that the dividend-paying corporation was the transferee of property upon which it did not ever itself realize an actual gain, but in respect of which the question arose whether there should be ascribed to it a gain or loss measured by reference to transferor's basis.

The second type of case which we will now consider, is the case in which the other party to the reorganization,—the transferor of the property,—became itself the dividend-paying corporation. In that type of case, the transferor did realize an actual gain or loss of its own upon the transfer. Because of the reorganization provisions no tax was recognized to it, however. The question that then arose was

whether, because the gain or loss had not yet been recognized, the corporation could avoid taking into its earnings and profits account the gain or loss that it had actually realized.

The question first arose in *Forhan Realty Corporation* (Memorandum Opinion in B. T. A., unreported, Docket No. 60975, decided June 16, 1933), reported on appeal when affirmed by C. C. A. 2d, *Commissioner* v. *Forhan Realty Corporation* (Feb. 4, 1935) 75 F. (2d) 268. The taxpayer owned shares in another corporation called the Forhan "Company". The "Company" had transferred all its assets in a tax-free reorganization to Zonite Products Corporation in exchange for common stock of Zonite and cash, which the "Company" then distributed to its shareholders, including the taxpayer. Actual gain was realized by the "Company" because the value of the Zonite stock and cash exceeded the cost of the assets transferred by the "Company" in exchange for them.

The case therefore turned in part upon whether the actual but unrecognized gain of the "Company" upon the exchange entered into the earnings and profits of the "Company". If it did, then the distribution to its stockholder (the taxpayer) was a dividend, and since the taxpayer was a corporation, it was non-taxable. If it did not, then the distribution was a return of capital and, to the extent only that it exceeded the cost of the stock to the taxpayer, would represent a taxable capital gain.

The Commissioner argued that under the statute (the same then as now) the gain was *not* to be taken into earnings and profits. The Board of Tax Appeals held that the gain upon the reorganization was to be taken forthwith into earnings and profits, because it was an actual corporate gain, although not yet recognized for tax purposes.

That decision, of course, opened a wide avenue of tax avoidance. The gain had not been recognized to the "Company" at the time it received the Zonite stock, and if the Zonite stock were distributed as a dividend to a corporate shareholder, no income tax would be paid upon that gain. The tax basis of the Zonite stock received as a dividend in the hands of the corporate shareholder would be its fair market value on the date it was received, and the corporate shareholder could subsequently sell such stock without the realization of gain.

The government appealed to the Circuit Court of Appeals for the 2nd Circuit, the brief being filed in September 1934. The Circuit Court of Appeals affirmed, *Commissioner* v. *Forhan Realty Corporation*, 75 F. (2d) 268 (C. C. A. 2d, Feb. 4, 1935).

Accordingly, that was the tax avoidance situation with which the Commissioner was faced at the time he promulgated his regulation (in early 1935).

The regulation was designed to postpone the bringing of actual gain into earnings and profits until "such gains * * * are recognized."

The purpose of the regulation was the opposite of what this Court now supposes; it was to *prevent* gain being brought into earnings and profits where the effect might be to lose tax upon it because it was disbursed as a non-taxable dividend, before tax accrued.

The question next arose in a case involving an individual taxpayer. But the principle was precisely the same, as the taxpayer's position is governed by that of the corporation making the distribution. However, before the taxation of intercorporate dividends in 1936, there might be a critical difference in the result. Where the tax-

payer was a corporation, as in *Forhan,* the Commissioner was asking that the gain should not be taken into earnings and profits; but where the taxpayer was an individual, and the capital gains tax rate was lower than the surtax rate on the dividend, the needs of the Revenue would favor the gain being taken immediately into earnings and profits account.

The Board of Tax Appeals consistently held in respect of individuals, as it had held in respect of corporate taxpayers in *Forhan,* that the gain upon the reorganization, although not recognized for tax purposes, was immediately taken into earnings and profits. And in the individual cases, as we have indicated, the Commissioner was content with the rule. The first such case was *Susan T. Freshman* (Nov. 1935) 33 B. T. A. 394. The facts underlying the decision are clearly stated in the following paragraph from the Board's opinion, 33 B. T. A. at 401:

> "The Pratt & Whitney Co. invested $500 of its earnings in 1925 in common stock of Pratt & Whitney Aircraft Co. This stock had increased enormously in value by 1929 and was exchanged in February 1929 solely for stock of United Aircraft Co. but the gain on the exchange was not recognized under the provisions of section 112(b)(3). The increase in value of the investment, which, after the exchange, was represented by the property received on exchange, was available for distribution as a dividend and was distributed by Pratt & Whitney to its sole stockholder, Niles-Bement-Pond. This dividend was an earning of Niles-Bement-Pond on its Pratt & Whitney stock, which earning was received on February 11, 1929, and was available for distribution by Niles-Bement-Pond to its stockholders. Niles-Bement-Pond immediately dis-

tributed practically all of the property received by it as a dividend to its stockholders. This was a distribution by a corporation to its stockholders in property out of earnings received after February 28, 1913."

The decision was reviewed by the Board and established the law in the Board on the question.

In another case three months later, the Board reached the identical result. *Robert R. McCormick* (Feb. 1936) 33 B. T. A. 1046. This decision was also reviewed by the Board.

The question arose again in the case of a corporate taxpayer before the 2nd Circuit Court of Appeals in *Ramapo Inc. v. Commissioner* (July 1936) 84 F. (2d) 986. The question had not been considered in the Board of Tax Appeals (32 B. T. A. 561), but was made a ground of decision in the C. C. A., 84 F. (2d) at 988. Like the *Forhan* situation, there had been a great increment in value, nontaxable because realized upon a reorganization, consequent upon transfer by Superpower Corporation of various securities which it exchanged for stock of United Corporation. The distribution to Superpower's stockholders (of which the taxpayer was one) was of rights to buy stock in United. The ground of decision was that those rights were to be taken to be a distribution out of the earnings and profits which had been provided by the great increment in value of the United stock over the securities transferred to Superpower in exchange therefor.

The *Ramapo* case involved a very large amount and provided striking confirmation of the risk of loss to the Revenue which had been forecast by the earlier decision of the same Court in *Forhan*, for the distributee corporate

stockholders avoided taxes upon the distribution, notwithstanding that no tax had been recognized to the distributor corporations. The Commissioner therefore filed a petition for rehearing, and Mr. Justice Jackson appeared on the Commissioner's brief as Assistant Attorney-General. The Commissioner's brief, in pointing out the avoidance of tax that resulted from taking into earnings and profits account the gains that had not themselves (because of the reorganization provisions) been recognized for tax purposes, made the first reference which we have found in any of the Commissioner's briefs to the regulation here under consideration, saying of it (in a footnote):

> "In Article 115 (1) of Regulations 86 promulgated under the Revenue Act of 1934, it is provided that gains are to be brought into the profits and loss account for the purpose of determining the earnings available for dividends *only* when they are recommended[5] under section 112." [Emphasis ours.]

The petition for rehearing was denied; but the Commissioner did not petition for a writ of certiorari.

Another case of an individual taxpayer arose before the Board in *Helen Sperry Lea* (Jan. 1937) 35 B. T. A. 243, and, after being reviewed by the Board, was decided in the same way, upon the authority of the *McCormick* case, *supra*, 33 B. T. A. 1046.

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[5]Evidently a misprint for "recognized". The word "only" shows what was in the brief-writer's mind, viz. that the regulation related to some gain that had in fact been realized and that the question was as to *when* such actual corporate gain was to be taken into earnings and profits account. To this the brief-writer answered: " 'only' when they are recognized under section 112."

It had now become established in the Board of Tax Appeals by five cases, two of which had been affirmed in the 2nd Circuit Court of Appeals, that the actual but taxless gains of a corporation were taken into earnings and profits so that distributions therefrom were to be treated as dividends. And this was settled as a matter of principle, regardless of whether the taxpayer happened to be an individual or a corporation, although under the law as to dividends as it stood prior to 1936, this meant that each case of an individual taxpayer was decided in favor of the Commissioner and each case of a corporate taxpayer was decided against the Commissioner. In this branch of the law, as in the other branch considered above, the Commissioner at this period, far from being "persistent" in applying a regulation, was arguing as best he could in support of whatever rule would in the particular case be favorable to the Revenue.

The sixth case of this sort, and the third involving a corporate taxpayer, was *F. J. Young Corporation* (April 1937) 35 B. T. A. 860. The Board pointed out in parallel columns the fact that the cases of individual and corporate taxpayers were indistinguishable, and decided in favor of the taxpayer on the authority of the decision in favor of the Commissioner in *Freshman, supra,* 33 B. T. A. 394. The Board was in *F. J. Young* simply continuing its perfectly consistent course, and it was not considered necessary for *F. J. Young* to be reviewed by the full Board. The Commissioner again appealed, however, this time to the 3rd Circuit Court of Appeals; but the 3rd Circuit Court of Appeals agreed with the 2nd Circuit and upheld the Board's view. *Commissioner* v. *F. J. Young Corporation* (March 1939) 103 F. (2d) 138.

The Commissioner was now ready to acquiesce in the position that a certain rule had become settled in the Courts, and (as with the earlier decisions of the 2nd Circuit), he did not apply for a writ of certiorari to this similar decision in the 3rd Circuit. He took the other course,—of seeking an amendment of the statute,—and obtained it in the 1940 Act which has been considered in this case.

That it was the *F. J. Young* decision that led to the enactment of the 1940 statute, is evidenced by the fact that it was that case and its precise facts which were cited in reports both of the House and of the Senate recommending the legislation. H. R. Rep. 2894, 76th Cong. 3d Sess., and Sen. Rep. 2114, 76th Cong. 3d Sess., both referred to in footnote 7 of this Court's opinion in this case, Slip Op. 3

F. J. Young was the final case of the second group. It was decided in March 1939. A C. C. A. decision of the first group was *Farish* in the 5th Circuit in July 1939 (four months later). If the Congress or the Commissioner considered that the questions were linked, one would have expected the *Farish* case to be considered and cited in the enactment of the 1940 Act just as the *Young* case was. But it was not. The evident intent of Congress was to change the doctrine of the *Young* case, which (as we have said) was used as the example in the House and Senate Reports. There is no indication in the Congressional history that the rule in the *Farish* case was meant to be affected at all.

IV.

Nor did Congress by the enactment of § 501 of the Second Revenue Act of 1940 evidence any intention to alter the established rule that only actual gains and losses enter into the computation of earnings and profits.

§ 501(a) refers repeatedly in terms to "realized" gains and losses, i.e., to actual gains and losses. (Our original brief Point II, pp. 30-40.) The statute is set forth in the Appendix to this petition.

But even assuming that Congress, by the Second Revenue Act of 1940, did intend to abolish the rule that only actual gains and losses enter into the computation of earnings and profits, the fact that Congress refused to apply the new statute to pending litigation shows clearly that it thought it was changing existing law by the 1940 statute. If this Court permits an ambiguous statement in a committee report that legislation is "clarifying" to prevent its being retroactive, no legislation ever need be retroactive; it can always express itself as "clarifying".

Recent decisions of this Court confirm the rule that a Treasury Regulation, which has no statutory basis, cannot be given effect. *Maass* v. *Higgins*, 312 U. S. 443. *Helvering* v. *Credit Alliance Corporation*, 316 U. S. 107. *Helvering* v. *Sabine Transportation Company, Inc.*, 318 U. S. 306. The Treasury Regulation in the instant case had no statutory basis. Congress did not legislate on the subject until it passed the Second Revenue Act of 1940.

V.

The phrase "for the purposes of this title" does not have the significance conjecturally assigned to it in the opinion of this Court.

This Court felt moved to conjecture as to the intent of Congress (saying, at Slip Op. p. 4, that "Congress appears to have provided") that the taxable, i.e., recognized, gain or loss should be the gain or loss to be taken into earnings and profits, because § 111(c) of the 1938 Act says that gain or loss shall be "recognized *for the purposes of this title.*" The italicized phrase is the only direct evidence of Congressional intent to which the Court's opinion points.

This Court doubtless did not realize that the phrase is contained at least fifteen times in the Revenue Act of 1938, and that similar expressions are contained numerous additional times. The phrase is used synonymously with expressions such as "as used in this title" or "when used in this title". Its unimportance as a substantive provision is high-lighted by the fact that the Committee Reports with respect to § 202(d) of the Revenue Act of 1924 (the predecessor of § 111(c)) omit the phrase altogether in paraphrasing the section. For instance, the Senate Finance Committee Report (Senate Report 398, 68th Cong., 1st Sess., p. 13) states:

> "(4) Subdivision (d) [111(c)] is merely informatory, stating that the amount of the gain determined under its provisions shall be recognized as provided in section 203 [112], which states those cases in which no gain or loss from a sale or exchange is recognized in those cases in which a limitation is placed upon the gain or loss to be recognized from the sale or exchange."

The phrase "for the purposes of this title" is used in §§ 13, 14, 332, 335, 336, 362, 405 and 406 of the 1938 Act with respect to definitions of taxable net income. It is used, together with the synonymous phrase "as used in this title", three times in § 117 of the 1938 Act, which defines the extent to which gains and losses are to be taken into account in computing taxable income. It is frequently used in connection with other definitions in the Act; see for instance §§ 272(h), 331(a), 361 and 402. The phrase "as used in this title" also is synonymously used in §§ 26, 27(a) and 271(a). The phrase "when used in this title" is used in § 48 and § 115.

Accordingly, if any significance is to be given to the phrase "for the purposes of this title", it can equally well be applied to evince a Congressional intention to conform earnings and profits to taxable income. If that be so, the Wheeler Company had a deficit. See Part Two of this petition.

PART TWO

Assuming the Court's Interpretation to Be Right, the Decision Below Must Be Affirmed on the Facts of This Case.

I.

The gains were prior to the regulation.

The regulation provides that gains and losses are to be taken into earnings and profits account "at the time" such gains and losses are recognized under section 112.

The regulation was promulgated in 1935 applicable to the 1934 and succeeding Acts.

At that time the earnings and profits account for 1933 and all prior years was closed.

But the full amount involved in this case results from transactions in 1931, 1932 and 1933 (R. 17).

In 1933 there occurred under the Court's decision a gain of $155,911.86. There was no regulation then in effect; and the gain was not an "earning or profit" under section 115; nor was it taken into "earnings or profits account."

When in the year 1935 the regulation came to be promulgated, however, it negatived the suggestion now implicit in the Court's opinion that it was applicable to these particular gains, for "the time" when it directed that such gains should be taken into "earnings or profits account" was already past.

The Court has properly treated the regulation not as merely interpretative but as directive.

We are not saying that a regulation of this character could not be retroactive. We are only following this Court

in giving to the regulation its literal meaning. As that meaning is to prescribe a time when gains "shall be taken into" some account, it negatives retroactivity in application.

The regulation does not say that prior gains shall be treated as if they had been taken into earnings or profits account.

II.

The gains are more than offset by non-taxable dividends to which the Court's theory equally applies.

This Court held that the "theory" ought to be "carried through":

> "It is sensible to carry through the theory in determining the tax effect of such transactions on earnings and profits" (Slip Op. 3).

The theory was

> "that in certain types of transactions the economic changes are not definitive enough to be given tax consequences" (*op. cit.*).

One type of transaction from which until 1936 the Congress withheld tax consequences was an intercorporate dividend.

In this case if the intercorporate dividends prior to 1936 be eliminated, the Wheeler Company still had a deficit even if the "gain" now under consideration be taken into earnings and profits.

Those non-taxable dividends were included by the Commissioner in determining the Company's earnings and profits (R. 17, 18). If actual income no longer be the test for determining earnings and profits, that $203,085.19

should be eliminated from the earnings of the Company. That would more than offset the Commissioner's addition of $179,314.99 on account of taxable "gains" with respect to sales of securities on which the Company had an actual loss. The $203,085.19 of non-taxable dividends was also (to quote this Court) a "figure that had no relation to taxation" (Slip Op. p. 3). It is as "reasonable" to eliminate that figure as to add the "gain", if reasonableness be the test.

"Carrying through" the Court's "theory", therefore, that tax consequences for earnings and profits purposes are not to attach to transactions from which the Congress withheld tax consequences for recognition of income purposes, the decision below must be affirmed.

WHEREFORE the respondents, by their counsel, respectfully pray that this case be reheard and reconsidered.

Respectfully submitted,

ELLIOTT H. WHEELER, *et al.*,
Executors of the Estate of JOHN H. WHEELER, Deceased, *et al.*,
Respondents,

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VINCENT H. O'DONNELL
ROSWELL MAGILL
GEORGE G. TYLER
Of Counsel

April 17, 1945.

Certificate of Counsel

I, Wm. Dwight Whitney, counsel for the respondents herein, do hereby certify that the foregoing petition for rehearing is presented in good faith and not for delay and that this certificate is made pursuant to Rule 33 of the rules of this Court.

Wm. Dwight Whitney

Motion to Withhold Issuance of Mandate

The respondents herein move this Court for an order enlarging the time for the issuance of mandate to the end that the mandate be withheld until after the disposition of the foregoing petition for rehearing.

Wm. Dwight Whitney
Counsel for Respondents

APPENDIX

Revenue Act of 1938, c. 289, 52 Stat. 447:

TITLE I—INCOME TAX

* * *

Subtitle C—Supplemental Provisions

* * *

Supplement B—Computation of Net Income

Sec. 111. Determination of Amount of, and Recognition of, Gain or Loss.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

* * *

Sec. 112. Recognition of Gain or Loss.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * *

(5) *Transfer to Corporation Controlled By Transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

* * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * *

(6) *Tax-free Exchanges Generally.*—If the property was acquired, after February 28, 1913, upon an exchange described in section 112(b) to (e), inclusive, the basis (except as provided in paragraph (15), (17), or (18) of this subsection) shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112(b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned

to such other property an amount equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

* * *

(8) *Property Acquired by Issuance of Stock or as Paid-in Surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

(c) *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions of section 117, the gain so recognized shall be considered as a short-term capital gain, except in the case of amounts distributed in complete liquidation. For the purpose of the preceding sentence, "complete liquidation" includes any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding, from the close of the taxable year during which is made the first of the series of distributions under the plan, (1) three years, if the first of such series of distributions is made in a taxable year beginning after December 31, 1937, or (2) two years, if the first of such series of distributions was made in a taxable year beginning before January 1, 1938. In the case of amounts distributed (whether before January 1, 1938, or on or after such date) in partial liquidation (other than a distribution to which the provisions of subsection (h) of the section

are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits.

* * *

Second Revenue Act of 1940, c. 757, 54 Stat. 974:

TITLE V—AMENDMENTS TO INTERNAL REVENUE CODE

SEC. 501. EARNINGS AND PROFITS OF CORPORATIONS.

(a) *Under Internal Revenue Code.*—Section 115 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsections:

"(l) *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

"(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

"(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the

adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided.

* * *

(b) *Effective Date of Amendment.*—The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

(c) *Under Prior Acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States.
(26 U. S. C. Supp. III, Sec. 115.)

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

Art. 621. *Dividends.*—The term "dividends" for the purpose of Title I (except when used in sections 203 (a) (4) and 208 (c) (1)) comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of its earnings or profits accumulated since February 28, 1913. Although interest on State bonds and certain other obligations is not taxable when received by a corporation, upon amalgamation with the other funds of the corporation such income loses its identity and when distributed to shareholders in dividends is taxable to the same extent as other dividends.

* * *

Art. 623. *Distributions out of earnings or profits accumulated, or increase in value of property accrued, prior to March 1, 1913.*—* * *

In determining whether a dividend is out of earnings or profits accumulated since February 28, 1913, or prior to March 1, 1913, due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive.

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

Art. 115-1. *Dividends.*—The term "dividends" for the purpose of Title I (except when used in sections 203 (a) (4) and 207 (c) (1)) comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of its earnings or profits accumulated since February 28, 1913. Among the items entering into the computation of corporate "earnings or profits" for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112, are brought into the earnings and profits account at the time and to the extent such gains and losses are recognized under that section. Although interest on State bonds and certain other obligations is not taxable when received by a corporation, when distributed to shareholders in dividends is taxable to the same extent as other dividends.

Treasury Regulations 94, promulgated under the Revenue Act of 1936; and Treasury Regulations 101, promulgated under the Revenue Act of 1938:

Art. 115-3. *Earnings or profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated

prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

HOUSE COMMITTEE REPORT

THE SECOND REVENUE BILL OF 1940

H. Rep. No. 2894, 76th Cong., 3d Sess., p. 41 (1940-2 Cum. Bull. 496, 526-527):

SECTION 401. EARNINGS AND PROFITS OF CORPORATIONS.

The purpose of this amendment is to clarify the law with respect to what constitutes earnings and profits of a corporation. This is important not only for the purpose of determining whether distributions are taxable dividends but also in determining equity invested capital for excess-profits-tax purposes.

Section 401 of the bill inserts subsection (l) in section 115 of the Internal Revenue Code and correspondingly amends prior Revenue Acts. The rule, applied by the Treasury under existing law, is that while gains or losses which are not recognized by reason of the provisions of sec-

tion 112 neither increase nor diminish the earnings or profits, the earnings or profits are increased or diminished by the entire amount of the recognized gain or loss, computed in accordance with the provisions of sections 111, 112 and 113. Together with the provisions of section 115 (h) of the Internal Revenue Code, and the principles established in *Commissioner* v. *Sansome* (60 Fed. (2d), 931) and following decisions, the rule effectuates the provisions of section 112. While taxpayers generally have concurred in the rule applied by the Treasury, the Board of Tax Appeals and some of the courts have not agreed but have followed the theory that gain or loss, even though not recognized in computing net income, nevertheless affects earnings and profits. For example, on January 1, 1930, the X Corporation owned stock in the Y Corporation which it had acquired in 1929 in a transaction wherein no gain or loss was recognized. The adjusted basis to the X Corporation of the property exchanged by it for the stock in the Y Corporation was $100. The fair market value of the stock in the Y Corporation received by the X Corporation was $1,000. On April 9, 1930, the X Corporation declared a cash dividend of $900 and, except for the possible effect of the transaction in 1929, had no accumulated earnings or profits as of that date. Under the interpretation of the Board and some of the courts, the excess of the fair market value of the stock of the Y Corporation over the basis, $900, would represent earnings or profits, and the cash distribution would be a taxable dividend (*Commissioner* v. *F. J. Young Corporation*, 103 Fed. (2d), 137). Under the proposed legislation and Treasury practice, the $900 would not represent earnings or profits, and the cash distribution would not be a taxable dividend. The need for certainty, not only with respect to the determination of when dividends are taxable but also in the computation of the excess profits tax credit, makes it desirable to clarify existing law.

* * *

SUPREME COURT OF THE UNITED STATES.

No. 354.—October Term, 194~~5~~4.

Commissioner of Internal Revenue,
Petitioner,
vs.
Elliott H. Wheeler, et al., Executors of the Estate of John H. Wheeler, Deceased, et al.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

[March 26, 1945.]

Mr. Justice Jackson delivered the opinion of the Court.

The Circuit Court of Appeals for the Ninth Circuit has held Section 501(a) of the Second Revenue Act of 1940 to be unconstitutional.[1] This of course called for grant of certiorari.[2]

Since our problem is not computation of a tax, the facts relevant to the issues in the five cases, consolidated on appeal, may be shortly stated. In 1925, John H. Wheeler and his wife, Frances, organized under the laws of California the John H. Wheeler Company. Then and thereafter they transferred an assortment of securities to it in exchange for shares of its common stock. The securities had cost them $304,683.49 and at transfer had a fair market value of $491,800. In exchange the Wheelers received 4918 shares with a par value of $100 each. No gain by them was recognized for income-tax purposes by reason of the exchange. Cf. Int. Rev. Code § 112(b)(5).

For purposes of determining its income-tax liability on subsequent disposition of the securities, the corporation was obliged to and did use as a cost base the cost of the securities to the transferors, $304,684.49. Cf. Int. Rev. Code § 113(a)(8). But for its corporate accounting the corporation set up a cost of $491,800, market value at the time of acquisition in exchange for common stock of equal par value. The whole question in this case is which of these bases is to be used to compute, pursuant to § 112(b)(7)(E) of the Revenue Act of 1938, 52 Stat. 447, 488, the amount of "earnings and profits" distributed as liquidating dividends. The Act of 1938, to induce corporate liquidations, permitted a qualified stockholder to elect postponement of a portion of the gain realized on a December 1938 liquidation and to be taxed, as for a dividend,

1 143 F. 2d 162.
2 — U. S. —.

on "so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation . . ." If the market-value basis is used for the securities acquired from the Wheelers and later sold, the operations of the Company showed a deficit on November 30, 1938, when the books were closed. If the cost-to-transferors basis is used, "earnings and profits" were distributed to respondents, the stockholders, in the amount of $132,813.48, as computed by the Commissioner.[3]

After considering the applicability of § 112(b)(7), the stockholders duly dissolved the corporation and distributed its assets during December 1938. They elected to be taxed on the gains on their shares pursuant to § 112(b)(7), and they reported, of course, according to the higher or market-value basis for the securities acquired and disposed of by the Company. The Commissioner asserted a deficiency based on the lower cost to the transferors. In explaining his determination he relied on § 501(a) of the Second Revenue Act of 1940, 54 Stat. 974, 1004, which provides that earnings and profits on the sale or other disposition of property shall be determined by using the adjusted basis for determining gains and by recognizing such gains to the extent that they are recognized for computing net income, and on § 501(c), which makes the provisions of § 501(a) applicable to prior years.

The Tax Court sustained the Commissioner.[4] It held § 501(a) of the Act of 1940 a "complete answer" to taxpayers' contention, and it overruled their claim that if the section was applicable to increase their 1938 liability it was retroactive in contravention of the Fifth Amendment to the Constitution. The Circuit Court of Appeals agreed that the section was applicable, but held that such retroactivity rendered it unconstitutional.

Although the term "earnings and profits" has long been in the revenue acts, in connection with the definition of dividends, it has never been defined by the statutes[5] (except in so far as § 501(a) of the Second Act of 1940 has now done so). But under the Revenue Act of 1934 and succeeding acts, the Commissioner dealt by regulation with that portion of the problem of definition relevant here. Article 115-3 of Treasury Regulations 101, promulgated under the 1938 Act, provided in part as follows: "Gains and losses within the purview of Section 112 or corresponding

[3] This was slightly modified by the Tax Court in an aspect not material here.

[4] 1 T. C. 640.

[5] See Paul, Selected Studies in Federal Taxation (Second Series, 1938) 149, 155 *et seq.*

provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section.[3] This regulation, if valid, disposes of the controversy, for when the corporation sold its securities acquired from the Wheelers it realized gain, based on transferor's cost, which was fully recognized under § 112.

The only reason to doubt the validity of the regulation is found in certain decisions of the Board of Tax Appeals and lower courts, mentioned in the Tax Court's opinion. Despite these adverse decisions, however, the Commissioner persisted in applying the regulation. The question was never reviewed here. Before it was finally judicially considered, Congress enacted § 501 of the Second Revenue Act of 1940, as the committee reports show,[7] to "clarify the law" by enacting the substance of the regulation. But if the regulation itself was valid and effective, the clarifying amendment of 1940 added nothing to the liability of these taxpayers; and even though the Tax Court relied on it rather than on the regulation, no question of retroactivity is presented.

We think the regulation is reasonable and a valid exercise of the rule-making power. The taxpayers are insisting on using as a base for tax purposes a figure that in itself had no relation to taxation. It was no doubt permissible and perhaps the correct accounting, for determining earned surplus for dividends and such corporate purposes, for the corporation to set up its books on the market value of its property at the time of acquisition, which determined the value of the stock it issued. But "earnings and profits" in the tax sense, although it does not correspond exactly to taxable income, does not necessarily follow corporate accounting concepts, either.[8] Congress has determined that in certain types of transaction the economic changes are not definitive enough to be given tax consequences, and has clearly provided that gains and losses on such transactions shall not be recognized for income-tax liability but shall be taken account of later. §§ 112, 113. It is sensible to carry through the theory in determining the tax effect of such transactions on earnings and profits. Compare *Commissioner* v. *Sansome*, 60 F. 2d 931, and see Sen. Rep. No. 2156, 74th Cong., 2d Sess., p. 19; H. R. Rep. No. 2894, 76th Cong.,

[3] The provision appears in Reg. 94, Art. 115-3, under the Act of 1936; Reg. 86, Art. 115-1, under the Act of 1934; and in Reg. 103, Sec. 19.115-3 and Reg. 111, Sec. 29.115-3 under the Internal Revenue Code.

[7] See H. R. Rep. No. 2894, 76th Cong., 3d Sess., p. 41; Sen. Rep. No. 2114, 76th Cong., 3d Sess., p. 22.

[8] See 1 Mertens, Law of Federal Income Taxation (1942) § 9.33.

3d Sess., p. 4? Indeed, Congress appears to have provided for this result in the statute itself (§ 111(c) of the 1938 Act), which declares: "In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized *for the purposes of this title*, shall be determined under the provisions of section 112."[9] In this case, to be sure, there was no question of recognition of gain or loss to the corporation at the time of the exchange with the Wheelers, because it was issuing its own stock and so realized no gain or loss. But to recognize the increment in value as affecting earnings and profits would no more harmonize with the taxless character of the transaction than to treat a realized gain as doing so. The same policy which carries over the transferor's basis for purposes of the corporation's income tax (§ 113(a)(8)) requires carrying it over for determining the taxability of its distributions, as the Commissioner's regulation directs: gains and losses are to be brought into earnings and profits at the time and "to the extent" that they are recognized under § 112. Finally, no doubt of the reasonableness of the rule can linger in the presence of § 501(a), by which Congress has indicated its express approval of the principle that the basis for determining earnings and profits shall be the basis for determining gain.

We therefore think that on principles often reiterated[10] the regulation is valid and decisive of this issue. There is no necessity to predicate the determination of deficiency on the 1940 amendment. The 1940 amendment consequently has no retroactive effect on the liability of these taxpayers and the conclusion of the Court of Appeals that it is unconstitutional is not warranted. The judgment of the Court of Appeals is reversed and that of the Tax Court is affirmed.

Reversed.

Mr. Justice Roberts is of opinion the judgment should be affirmed for the reasons stated by the Circuit Court of Appeals, 143 F. 2d 162.

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[9] (Ital. supplied.) See Paul, Selected Studies in Federal Taxation (Second Series, 1938) 193-95.

[10] Boske v. Comingore, 177 U. S. 459, 470; Brewster v. Gage, 280 U. S. 327, 336; United States v. Kirby Lumber Co., 284 U. S. 1, 3; Fawcus Machine Co. v. United States, 282 U. S. 375, 378. It may also be noted that the regulation has the support of the doctrine that re-enactment of the statute without disapproval of regulations thereunder gives them added sanction. United States v. Dakota-Montana Oil Co., 288 U. S. 459, 466; Helvering v. Winmill, 305 U. S. 79, 83; Helvering v. Griffiths, 318 U. S. 371, 395, 397.